United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

11/4/76

76-7439

To be argued by:
MARC P. CHERNO

IN THE

United States Court of Appeals

For the Second Circuit

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of CONTINENTAL STEEL CORPORATION similarly situated,

Plaintiff-Appellee,

v.

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, JAMES F. MORRILL,

Defendants,

PENN-DIXIE INDUSTRIES, INC. (formerly Penn-Dixie Cement Corporation), JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, JAMES F. MORRILL,

Defendants-Appellants.

BRIEF OF THE APPELLANTS

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
Attorneys for Appellant
Penn-Dixie Industries, Inc.

ARANOW, BRODSKY, BOHLINGER, BENETAR & EINHORN
Attorneys for Appellants
Jerome Castle, Omar J. Glantz, James C. Jacobsen, Harvey Kushner, Alfonso J. Marcelle and James F. Morrill

Of Counsel:

MARC P. CHERNO
JOSEPH H. EINSTEIN
ALAN J. RUSSO

TABLE OF CONTENTS

Table of Cases Cited

Statutes and Authorities Cited

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 76-7439

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of CONTINENTAL STEEL CORPORATION similarly situated,

Plaintiff-Appellee,

v.

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, JAMES F. MORRILL,

Defendants,

PENN-DIXIE INDUSTRIES, INC. (formerly Penn-Dixie Cement Corporation), JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, JAMES F. MORRILL,

Defendants-Appellants.

BRIEF OF THE APPELLANTS

Preliminary Statement

This is an appeal from an order of the United States District Court for the Southern District of New York (Metzner, J.) granting plaintiff's application for class action designation. The decision of the Court has not been reported.

Statement of the Issue Presented for Review

Is a plaintiff a proper class representative when he admits that, as a former principal executive officer of the corporate defendant, he intentionally participated in certain of the allegedly wrongful conduct complained of, with knowledge that this conduct was harmful to class members?

Statement of the Case

(a) Nature and status of the case

The amended complaint* in this action, instituted under Sections 10(b) and 14(a) of the Securities Exchange Act of 1934, alleges a scheme on the part of Penn-Dixie Cement Corporation ("Penn-Dixie") to (1) gain majority control of Continental Steel Corporation ("Continental"); (2) depress the value of Continental stock through a number of allegedly manipulative practices; and (3) effect a merger between Penn-Dixie and Continental which, because of the manipulative lowering of the value of Continental stock, was on terms that were unfair to Continental shareholders. The defendants are Penn-Dixie and certain former officers and directors of Penn-Dixie and Continental.

This appeal is from the decision of the District Court granting the application of plaintiff, John Schlick ("Schlick"), to have this action designated as a class action pursuant to Rule 23 of the Federal Rules of Civil

---

* The District Court dismissed the original complaint in this action for failure to state a claim upon which relief could be granted. On appeal, this Court reversed and remanded the judgment dismissing the complaint. *Schlick* v. *Penn-Dixie Cement Corp.*, CCH Fed. Sec. L. Rep. ¶ 94,163 (S.D.N.Y. 1973), *rev'd*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). Plaintiff subsequently sought and was granted leave to file an amended complaint (App. 244a). In response to the amended complaint, defendants have filed answers and have asserted counterclaims against plaintiff for contribution, predicated on plaintiff's admitted participation in the allegedly wrongful conduct set forth in the amended complaint (App. 271a-292a).

Procedure, and certifying plaintiff as a proper representative of the class. The Court, in granting the motion, did not write a separate opinion (App. 242a), but rather adopted the report of Magistrate Schreiber (App. 228a), to whom the motion had been referred to hear and report.

The Court found, in essence, that plaintiff's admitted participation in certain of the allegedly wrongful conduct did not bar him from acting as the representative of the shareholders supposedly wronged by this conduct. In so doing, the Court, for the first time that we know of, has sanctioned the representation by an admitted wrongdoer of the persons he has concededly wronged.

(b) Plaintiff's participation in the allegedly wrongful conduct

Plaintiff was the Executive Vice-President of Penn-Dixie—the number two man in the company—at the time that Penn-Dixie obtained majority control of Continental, the first step in the alleged scheme set forth in the amended complaint.*

As Penn-Dixie's Executive Vice-President, it was plaintiff who was personally responsible for authorizing, planning, extensively negotiating, and implementing the stock acquisition which gave Penn-Dixie its majority stock control over Continental.** Moreover, he took these actions at a time when he says that he had concluded that Penn-Dixie was engaged in "highly improper" practices detrimental to Continental's shareholders and that he knew that the ultimate purpose of these supposed practices was a merger between Penn-Dixie and Continental (App. 8a, 69a, 77a).

---

* Plaintiff has testified that at this time he was "responsible for the total financial and administration" of Penn-Dixie (App. 137a).

** The relevant material on this subject can be found at App. 94a-99a and 158a-170a. Plaintiff also voted as a Penn-Dixie director to authorize Penn-Dixie's purchases of Continental stock (App. 155a, 167a).

Thus, even accepting plaintiff's characterizations, it was his own knowing conduct which, in the first instance, put Penn-Dixie in the position to effectuate its alleged scheme to depress the value of Continental stock and accomplish an unfair merger.

Plaintiff continued in his position of prominence as the supposed scheme to depress Continental's stock value unfolded. According to the amended complaint, one of the most important aspects of this "scheme" was the reduction of the dividend paid to Continental's shareholders. The amended complaint alleges, in this regard, that:

> "The decrease in the dividend was designed and did have the effect of severely decreasing the price that the shares of Continental were traded at on the New York Stock Exchange, thus severely prejudicing the exchange ratio to the detriment of the Continental shareholders." (App. 257a-258a)

On this subject, in what is probably the most significant evidence relative to this appeal, plaintiff testified unequivocally that, as a member of Continental's board, on April 15, 1969, he voted for the decreased dividend although he knew that this was contrary to the best interests of Continental shareholders:

> "Q. Is it your position, Mr. Schlick, that Continental Steel should have paid the same dividend in 1969 that it paid in 1968? A. It was my opinion that they should have paid the same dividend.
>
> Q. Were you voting contrary to your opinion when, as a member of Continental's board in 1969, you voted for a much smaller dividend? A. Yes, on the basis that, as I recall, on the basis that Mr. Castle only wanted unanimous opinions and it was one of the factors amongst which caused my resignation.

> Q. In other words, *you cast a vote which was contrary to your opinion and beliefs as to what was in the best interests of Continental shareholders; is that correct?* A. *Yes.*" (App. 61a-62a, emphasis added).*

Although this should, we submit, by itself be sufficient to disqualify plaintiff from representing these same shareholders, this is not the limit of plaintiff's involvement with the alleged scheme. Thus, the amended complaint further alleges that, as part of the manipulative scheme, Penn-Dixie engaged in improper inter-company transactions with Continental in which Penn-Dixie received unduly favorable terms:

> "Upon information and belief, the defendants, through their domination of the Continental Board of Directors, caused Continental or its subsidiaries, to sell steel products and/or make other arrangements with Penn-Dixie or its subsidiaries, under terms and conditions more favorable to Penn-Dixie, than it would sell or distribute its products to a non-affiliated customer." (App. 258a)

Plaintiff, as a Penn-Dixie representative on the Continental Board, was one of the principal persons through whom Penn-Dixie exercised its supposed domination of Continental in this regard. In fact, plaintiff testified that

---

* While the Magistrate's report appeared to rely in part on the argument that plaintiff's vote related to a continuation of the reduced dividend, rather than its initial reduction three months earlier (App. 237a), it ignored the fact that plaintiff was necessarily involved in the initial reduction as well, since he testified that at that time he was in charge of the financial policies for the Penn-Dixie organization (App. 137a). Indeed, on the very date of the initial dividend reduction (January 21, 1969), Schlick formally was nominated as one of Penn-Dixie's designees on the Continental Board (App. 173a). In any event, the Magistrate's report concedes the possibility that plaintiff "may be held liable to the class of Continental shareholders for . . . the scheme to depress the price of Continental stock" (App. 237a).

he knew, as a director of both Penn-Dixie and Continental, that these alleged practices were taking place (App. 63a-64a), yet he acquiesced in them and did nothing whatever to protect Continental's shareholders, despite the fiduciary duty he owed to these shareholders. Indeed, plaintiff stated that he personally "was involved" in the operations of the Penn-Dixie subsidiary (Hausman Corporation) which was supposedly making these purchases on unduly favorable terms "from Continental Steel during my tenure" (App. 64a). Plaintiff testified on this subject as follows:

> "Q. What specific facts do you have, Mr. Schlick, in support of your allegation that Continental Steel was caused to sell steel products to Penn-Dixie or its subsidiaries or affiliates on terms more favorable to Penn-Dixie than to non-affiliated companies? A. Continental Steel sold reinforcing bars to the Hausman Company—I believe that's the name, when I referred to Fred Hausman over there, which had a number of warehouses for the sale of that throughout the country, and *to my knowledge* there were longer credit terms extended through the inter-company process to Hausman than was general to other customers.
>
> Q. You say that is to your knowledge? A. That's right.
>
> Q. Can you tell us how you came by that knowledge? A. *Well, I was involved in not only, in the Fred Hausman operations to some extent, and was aware of their purchases from Continental Steel during my tenure.*
>
> Q. *So your testimony is that this took place during your tenure?* A. *Yes.*" (App. 63a-64a, emphasis added.)

Moreover, long after plaintiff says that he knew of Penn-Dixie's base designs on Continental, he recommended

that it was to Penn-Dixie's "advantage" to sell its Hausman subsidiary to Continental for a "premium", and to amalgamate the Penn-Dixie and Continental steel operations, and further urged that Penn-Dixie take a greater managerial role in Continental's affairs (App. 184a, 71a-74a). And, long after plaintiff says he learned of the "highly improper" practices of Penn-Dixie's management regarding Continental, and despite the fiduciary duties owed to Continental shareholders, he continued to participate as a director of both companies, and also cast his vote as a shareholder for the management designees to the Penn-Dixie and Continental boards (App. 83a, 142a).

In sum, the undisputed record—consisting of plaintiff's own testimony and statements—shows that plaintiff has participated in the supposed "conspiracy" alleged in the amended complaint in a number of critical respects, and, by his own admission, intentionally acted directly contrary to the interests of the class he now seeks to represent.*

(c) The Magistrate's report

In recommending that plaintiff be designated a proper class representative despite his admitted participation in the conduct in question, the Magistrate's report deals only with plaintiff's vote at the April 15, 1969 Continental Board of Directors meeting in support of the reduced Continental dividend.

Stating that this vote for the reduced dividend was the "single act . . . that defendants rely on in attacking Schlick's status as a proper class representative" (App.

* Defendants vigorously deny that there were in fact any wrongful acts, scheme, or conspiracy, and plaintiff has already admitted that many of his claims were asserted without any factual support whatever and without any investigation into their accuracy (*e.g.*, App. 44a-45a, 2a-31a, 41a-42a). But the point is that assuming *arguendo* that there was wrongful conduct, plaintiff has admitted knowing participation in it.

235a), the report concluded that this should not prevent plaintiff from acting as class representative since:

> (1) it was only possible, and "far from certain," that Schlick will be held liable to the class for his activities in relation to the alleged scheme to depress the price of Continental shares (App. 237a-238a), and
>
> (2) "[i]t is Schlick's contention" that he "was prompted by pressure exerted by" another board member to vote to "continue in effect the 'depressed' 25¢ dividend even though he knew that a higher dividend ought to have been declared" (App. 237a-238a).

As noted, the District Court adopted the Magistrate's report, and held that plaintiff was a proper class representative, without writing a separate opinion (App. 243a).*

ARGUMENT

Plaintiff's admitted participation in the wrongful conduct alleged in the complaint, and his consequent interest in avoiding personal liability, prevent him from representing the class of shareholders he has admittedly wronged.

(a) The guiding principles

We know of no previous cases which have certified as a class representative a plaintiff who, according to his own testimony, has knowingly acted to injure the very shareholders he seeks to represent with respect to the subject matter at issue.

---

* The District Court also denied defendants' motion for certification pursuant to 28 U.S.C. § 1292(b). On October 19, 1976, this Court, after argument, denied plaintiff's motion to dismiss this appeal for lack of jurisdiction, without prejudice to renewal to the panel hearing the appeal.

There is, as far as we can see, very little direct learning from the courts of appeals on the explicit question of whether a self-admitted wrongdoer may represent the class of persons he has admittedly wronged—probably because very few plaintiffs have been so disingenuous as to seek to be class representatives in these circumstances. Nonetheless, we believe that the guiding principle as set down by the courts is clear—that, as this Court put it, the requirement of Rule 23(a)(4) of the Federal Rules of Civil Procedure that a plaintiff "will fairly and adequately protect the interests of the class" cannot be met where the "plaintiff has interests antagonistic to those of the remainder of the class" (*Eisen* v. *Carlisle & Jacquelin*, 391 F.2d 555, 562 (2d Cir. 1968)). We submit that the present decision cannot conceivably accord with this mandate.

Indeed, in the application of this principle, it is difficult to conceive of a more inherent conflict of interest than that presented by a self-labelled wrongdoer representing the very persons he claims to have injured. In this situation, a plaintiff must necessarily be influenced in all of his decisions throughout the litigation by the desire to avoid personal liability either to the class members themselves, or to the defendants for contribution where, as here, there have been counterclaims asserted.

This personal interest is fundamentally inimical to and in conflict with the interests of other class members. If, for example, the allegations in the amended complaint regarding reduced dividends or improper inter-company transactions were ultimately proven, the class members would, of course, benefit, but a judgment could be rendered against plaintiff personally for many millions of dollars.*

* Plaintiff has suggested that the damages in this case will approximate $20,000,000 (App. 9a).

It seems evident that plaintiff's interest in avoiding such a judgment is not only adv to class interests, but also is likely to far outweigh any "stake" he might have in a class recovery.

Nor is the conflict inherent in his situation in any sense "potential" or "remote," as the Magistrate's report suggests. On the contrary, it infuses every aspect of the conduct of this litigation, from the drafting of the complaint through the conclusion of trial. Where a plaintiff has admittedly participated in certain of the allegedly wrongful acts set forth in the complaint (and, in fact, is the subject of counterclaims with respect to those acts), and not in others, his inclination is likely to be to press most vigorously those claims as to which he has the least personal connection or potential liability, and to de-emphasize, ignore or abandon the claims in which he has personal exposure. And this conflict is inherent in every decision that must be made on a daily basis throughout the litigation—in the determination of questions such as which persons to name as defendants in the first instance, which witnesses to depose, what discovery to seek, and what terms to seek in settlement discussions, and culminating in the ultimate decisions on which claims to press at trial.*

In short, the conflict here is present, pervasive and fundamental and goes to the heart of our adversary system, which posits that the court must rely on the parties to choose which claims to press and which evidence to

* This has already been evident in the present case. Indeed, at the outset, plaintiff chose to name as defendants the Penn-Dixie directors at the time of the 1973 merger, but not the persons, like plaintiff himself and John Weldon, another client of plaintiff's counsel, who were Penn-Dixie or Continental directors at the time of many of the alleged manipulative practices, but not at the effective date of the merger. And already, during the argument on this motion before the Magistrate, plaintiff's counsel has referred to the claims involving plaintiff's participation as "minor" ones which had been "blown totally out of proportion." (Transcript of argument, p. 9.)

present. Where, as here, a class of absentee stockholders is to be bound by a judgment, the representative party's conduct in adducing the evidence and legal authority must not be tainted or distorted by even the appearance of personal interests which are in conflict with those of the class.

And, while plaintiff will undoubtedly ask rhetorically why defendants seem to be pressing so vigorously to protect the interests of members of a plaintiff-class, the answer is a two-fold one. In the first place, defendants, of necessity, must serve as the champions of Rule 23's requirement of adequate representation, just as plaintiffs serve as champions of the substantive requirements of the securities laws.

More importantly, if any questions are raised, after judgment, about the adequacy of plaintiff's representation, defendants may well be faced with the necessity of litigating the issues in question a second time. Ever since the Supreme Court's seminal decision in *Hansberry* v. *Lee*, 311 U.S. 32 (1940), it has been established law that a judgment is not binding upon absent class members if, in fact, their interests have not received fair and adequate representation from the supposed class representative.* It is, therefore, of utmost practical importance to defendants that there be no significant question about the adequacy of representation, and that all such questions be conclusively resolved at the outset. Otherwise, defendants will be in the worst possible position, where a judgment for plaintiffs at trial is conclusive, but a judgment for defendants may only be the first step along an endless road. This is, we submit, precisely the situation that the rule barring a plaintiff with "interests antagonistic to those

* This principle is discussed more fully at pp. 21-26, *infra*.

of the remainder of the class" (*Eisen* v. *Carlisle & Jacquelin, supra*) from acting as class representative is intended to prevent.

(b) The applicable authorities

Until the present case, the decisions which have dealt with conflicts between a class action plaintiff and the absent persons proposed to be represented by him have recognized and applied the foregoing considerations, and the principle, as recently reconfirmed by the Supreme Court, "that a 'stockholder has no standing if either he or his vendor participated or acquiesced in the wrong. . . .'" *Bangor Punta Operations* v. *Bangor & A.R. Co.*, 417 U.S. 703, 714 (1974). In fact, no case prior to the present case that we know of has granted class action status when the plaintiff has admittedly participated in the wrongs alleged. Indeed, when tested against cases in which class action status was denied for similar reasons, we submit that the instant suit presents an *a fortiori* case requiring denial of the class action application.

Thus, for example, in its recent decision in *G. A. Enterprises, Inc.* v. *Leisure Living Communities, Inc.*, 517 F.2d 24 (1st Cir. 1975), the Court of Appeals for the First Circuit held that plaintiff was unable to provide fair and adequate representation where his separate interests stemming from his individual business relationship with the subject corporation (Leisure Living),

> ". . . were adverse to the interests of the other shareholders of Leisure Living, and that this 'antagonism' was the kind which could influence the conduct of the litigation." (517 F.2d at 25.)

In *G. A. Enterprises*, plaintiff alleged that "the principal officers and directors of Leisure Living" had engaged

in "mismanagement and waste" (*id.* at 25, n. 1). Although the action was brought as a derivative suit, the Court noted that "the provisions governing class actions under Fed. R. Civ. P. 23(a)(3)-(4) . . . are essentially the same, however, and cases interpreting Rule 23 may be effectively utilized in analyzing the requirements of Rule 23.1" (517 F.2d at 26, n. 3). In finding that plaintiff was an inadequate representative, the Court pointed out that plaintiff (and its principal stockholder) had had business dealings with Leisure Living which were the subject of litigation, and that their claims against Leisure Living arising from these dealings were in themselves adverse to shareholder interests, and, moreover, were of greater "magnitude" than plaintiff's "stake in the derivative suit" (517 F.2d at 26).

The Court emphasized that inasmuch as the court must rely on the parties to properly develop and present the issues—and since absentee shareholders are to be bound by the judgment—it must be assured that a representative plaintiff's conduct of the litigation will be fair and adequate, and not distorted by his own separate interests:

> "[A] court's ability to oversee complex litigation and understand all its nuances is limited by its many other duties. In an adversary system a court must rely largely on the parties. Rule 23.1 recognizes the binding effect of derivative litigation on all stockholders and the company, and accordingly forbids maintenance of such a suit by a plaintiff unable to provide fair and adequate representation . . ." (*Id.* at 27)

Finally, the Court in *G. A. Enterprises* expressly rejected the argument—also asserted by plaintiff in the District Court in the present case—that plaintiff's individual involvements with the subject corporation would

cause him to be a better and "more vigorous" representative than he "might otherwise be" (517 F.2d at 26). The Court found that, to the contrary, the great disparity in size between plaintiff's personal interests, and his interests in his capacity as a stockholder, suggested that the representative claims would be "pursued, de-emphasized, or settled as the future course of the large claims might dictate" (517 F.2d at 26).

Similarly, in the case at bar, plaintiff Schlick has an obvious personal interest in avoiding literally millions of dollars of personal liability (either to the class members themselves or to defendants for contribution), based on the very conduct alleged in the amended complaint, an interest of vastly greater "magnitude" than his "stake" as a class member.

A similar result recently was reached by the Court of Appeals for the Ninth Circuit in *Hornreich* v. *Plant Industries, Inc.*, 535 F.2d 550 (9th Cir. 1976), a case in which separate personal interests which could influence the conduct of litigation were found to render plaintiff an inadequate representative even though these interests did not involve the same "subject matter" as the representative suit.

In *Hornreich*, plaintiff was a former director and employee of Plant Industries, Inc., who was engaged in a contract dispute with Plant's management unrelated to his proposed representative action. Suing derivatively and "on behalf of himself and all other shareholders" of Plant, plaintiff alleged misrepresentations and omissions in a proxy statement which was issued years after his departure from Plant's board, and which concerned a proposed corporate acquisition as to which plaintiff had no personal involvement.

Nevertheless, it was held that since it appeared that plaintiff's conduct of the representative suit might be influenced by his personal interests regarding his contract claims, the District Court properly concluded that plaintiff "could not fairly and adequately represent other shareholders" of Plant in a class action or derivative suit (535 F.2d at 551-552).

If, as *Hornreich* indicates, the adequacy of representation requirement is not met where the plaintiff might be influenced by personal interests *unrelated to the facts at issue,* then, *a fortiori,* the test has not been met where the conflict involves plaintiff's interest in avoiding liability based on the *very transactions at issue.*

Again, in *Nolen* v. *Shaw-Walker Co.,* 449 F.2d 506 (6th Cir. 1971), plaintiff sought to maintain a class and derivative action on behalf of minority stockholders of Shaw-Walker against certain corporate directors, seeking damages for mismanagement and "wrongful failure to declare dividends" (*id.* at 507). However, the Court found that plaintiff's conduct of the litigation would be influenced by personal considerations apart from the enforcement of the claims stated in the complaint and concluded that plaintiff

> " . . . cannot fairly and adequately represent the interests of the shareholders with the totality of the commitment to shareholder interest required by the litigant carrying the banner for the rights of the corporation." (*Id.* at 508.)

We have found no case in which this Court has expressly spoken to the question of whether a plaintiff who has admittedly participated in the allegedly wrongful conduct may nevertheless act as a class representative in attacking that

conduct. But the decisions of the district courts in this circuit, other than in the present case, clearly hold that a plaintiff cannot be a class representative in this situation. Indeed, there are two recent District Court cases reaching this result which were decided subsequent to the decision in the present case.

In *Domaco Venture Capital Fund* v. *Teltronics Services, Inc.*, 74 Civ. 3014, *noted in* CCH Fed. Sec. L. Rep. ¶ 95,687 (S.D.N.Y. Aug. 11, 1976), the Court denied class action designation primarily because the plaintiff, as the result of a claim by the defendants for contribution, "faces personal liability to those parties he is suing in the class action based upon a claim which bears a substantial factual relationship to the claim which [plaintiff] seeks to press on behalf of the class" (opinion, p. 7). The Court noted that in this situation, plaintiff "is therefore subject to pressures which may cause him to protect his interests to the detriment of the interests of the class" (opinion, pp. 5-6).*

Again, in *Bartels* v. *Newirth*, 75 Civ. 5664, *noted in* CCH Fed. Sec. L. Rep. ¶ 95,718 (S.D.N.Y. Sept. 9, 1976), the Court dismissed plaintiffs' derivative claims, and held that they were "estopped" from prosecuting them, on finding that plaintiffs were former corporate "insiders" who "might well have been named as defendants" in view of their "admitted participation" in the alleged transactions. The Court also noted that defendants "indicate an intention to file counterclaims" against certain plaintiffs based on their conduct as corporate officers,** and concluded that in

---

* The decision in *Domaco* has been appealed to this Court, and staff counsel to the Court has suggested that that appeal and the present appeal be heard by the same panel.

** Such counterclaims have, of course, already been asserted in the present case.

this situation plaintiffs could not "fairly and adequately represent" the corporation's interest.*

See also, *Kraus* v. *Paterson Parchment Paper Co.*, 65 F.R.D. 368, 369 (S.D.N.Y. 1974), where the Court determined, in a purported securities class action, that:

> "... the possible defenses available to defendants as to Kraus as distinguished from the members of the class which he seeks to represent, satisfy the Court that he could not fairly and adequately protect the interests of the class. Accordingly, his motion to maintain this action as a class action pursuant to Rule 23 is denied."

The same principles have also been recognized in other circuits; we mention here only some additional representative cases.

In *Traylor* v. *Marine Corp.*, 328 F.Supp. 382 (E.D. Wis. 1971), plaintiffs sought to maintain a class action on behalf

---

* The Court in *Bartels* expressly rejected the argument—apparently accepted in the Magistrate's report in the present case—that plaintiffs' own admitted participation in the challenged conduct could somehow be overlooked because of influence allegedly exerted by one of the defendants; the Court commented:

> ". . . unless the Court was to conclude that there is no liability on the part of a director who is under the 'control' of another, there remains the possibility that plaintiffs participated in the fraud allegedly perpetrated by Newirth. Upon a review of the record, the Court concludes that nothing more than plaintiffs' bare allegations of innocence in the transactions distinguish them from the persons they state have incurred liability under the securities laws and for breach of fiduciary duty." (Opinion, p.8.)

We suggest that, insofar as plaintiff's position in the present case is based on the thought that he was "pressured" in some unspecified manner into improper conduct, this hardly demonstrates the forthrightness required of a class representative. Indeed, it emphasizes the likelihood that litigation decisions will be guided by personal interests, in continuing disregard of the interests of shareholders.

of minority shareholders of Polaris Corporation, claiming that corporate assets were fraudulently sold on terms that were detrimental to such shareholders. The Court determined, however, that plaintiffs were not proper class representatives, solely on the ground that since one of the two named plaintiffs was a former director of Polaris, his interests "might well" diverge from those of absent class members:

> "The defendants further claim that this is not an appropriate class action under Rule 23, Federal Rules of Civil Procedure. The plaintiffs purport to represent all minority stockholders as a class. I am not persuaded that the plaintiffs are fairly representative of such class. They are entitled to bring the action in their own names for the wrongs allegedly caused, but it does not follow that they fairly represent all other minority stockholders. *Mr. Traylor was a director of Polaris, and in that capacity his legal relationship to the corporation and to the transactions in question might well make his interest divergent and his rights different from other minority stockholders.*" (328 F.Supp. at 383, emphasis added.)

In *Horwitz* v. *Panhandle Eastern Pipe Line Co.*, 293 F. Supp. 1092 (W.D. Okla. 1968), plaintiffs sought to maintain a class action under the securities laws, alleging that they and other stockholders of Natural Oil & Gas Producing Company ("Natural") had been misled by a false engineering report provided by defendant. In denying plaintiffs' class action motion, the Court pointed out that plaintiffs themselves had previously been underwriters, dealers or "control persons" of Natural, and that

> ". . . As underwriters and dealers or as control persons (of Natural), these named Plaintiffs may them-

> selves be the target of a 10b-5 action by the stockholders who bought Natural stock from them." (*Id. at* 1093.)

The Court concluded that "in these circumstances, a class action cannot be permitted."

The inappropriateness of class action certification is even clearer in the case at bar than it was in *Horwitz*. In *Horwitz*, the named plaintiffs could at least contend they stood in the same position as other stockholders in that they had not affirmatively participated in the alleged wrongdoing. By contrast, in the case at bar, plaintiff Schlick has testified that he knowingly participated in certain of the very conduct on which he now predicates his proposed class action. And, while the plaintiffs in *Horwitz* were disqualified simply because they "may" have become "the target of a 10b-5 action" based on the subject matter in suit (293 F. Supp. at 1093), plaintiff in the present case is already the target of substantial counterclaims against him.

Adise v. *Mather*, 56 F.R.D. 492 (D. Colo. 1972), is another instructive case. In that case, plaintiff sought to maintain a shareholders' class action under the securities laws, alleging that a prospectus contained false financial information. The challenged financial statements had been certified by the accounting firm of Haskins & Sells; plaintiff's deposition revealed that plaintiff himself used Haskins & Sells as his accountants, and that plaintiff had decided not to name Haskins & Sells as a defendant "regardless of whether or not Haskins, in the context of this case, had committed a wrong" (56 F.R.D. at 496).

On the basis of this fact—demonstrating an inherent conflict between plaintiff's personal interests and those of the class—the Court held that plaintiff "cannot fairly and

adequately represent the interests of the class'' (*id.* at 495-496), and that a class action was inappropriate.

The Court in *Adise* recognized that a plaintiff is an inadequate and inappropriate representative where his litigation judgment might be influenced by his relationship to a potential defendant. *A fortiori*, where, as in the case at bar, the conflict is not merely tangential, but inheres in plaintiff's own personal involvement in the alleged wrongs, we submit that plaintiff's inadequacy is beyond serious dispute.

See also, duPont v. *Wyly*, 61 F.R.D. 615 (D. Del., 1973), where the Court denied class action status in a securities action upon finding that, because of personal interests, plaintiff's conduct of the litigation ''could be influenced by considerations foreign to the interests of the class'' (*id.* at 622). The Court pointed out that ''the assurance demanded by due process and Rule 23 is that the representative party in a class action be free of any interest which holds the potential of influencing his conduct of the litigation in a manner inconsistent with the interests of the class'' (*id.* at 624).

In sum, until the present case, the courts have not permitted plaintiffs to represent absent shareholders where the plaintiff is ''subject to pressures which may cause him to protect his interests to the detriment of the interest of the class'' (*Domaco Venture Capital Fund* v. *Teltronics Services, Inc., supra*). Indeed, the courts have applied this principle so as to disqualify plaintiffs with putative conflicts that are far less egregious than that presented when, as in the case at bar, the plaintiff has admittedly participated in certain of the allegedly wrongful conduct, and testifies that he has knowingly acted ''contrary to [his] opinion and

beliefs as to what was in the best interests" of the class he now seeks to represent (App. 62a).*

(c) The due process considerations

The theoretical underpinning of the cases that have been discussed is found in the due process clause of the Constitution. As Chief Justice Stone stated in the landmark case of *Hansberry* v. *Lee*, 311 U.S. 32, 45 (1940):

> "a selection of representatives for purposes of litigation, whose substantial interests are not necessarily or even probably the same as those whom they are deemed to represent, does not afford that protection to absent parties which due process requires."

Similarly, in *Sam Fox Publishing Co.* v. *United States*, 366 U.S. 683, 691 (1961), the Supreme Court reaffirmed that the "judgment in a class action will bind only those members of the class whose interests have been adequately represented by existing parties to the litigation."

This Court has also continually reiterated this fundamental principle. In *Carroll* v. *American Federation of*

---

* None of the cases cited in the Magistrate's report in fact reach a contrary result. Indeed, the principal case relied on, *Mersay* v. *First Republic Corp. of America*, 43 F.R.D. 465 (S.D.N.Y. 1968), granted class action status only because the alleged conflict there involved had nothing whatever to do with the "issue in litigation." But the Court made it clear that where, as in the present case, the conflict relates to the issues in litigation, the plaintiff cannot be a proper class representative:

> ". . . Defendants cite cases such as *Carroll* v. *Associated Musicians of Greater New York*, 316 F.2d 574 (2d Cir. 1963); *Giordano* v. *RCA*, 183 F.2d 558 (3d Cir. 1950), and *Associated Orchestra Leaders of Greater Philadelphia* v. *Philadelphia Musical Soc., etc.*, 203 F. Supp. 755 (E.D. Pa. 1962). In each of these cases, the class action was dismissed because there was a substantial conflict within the class *over the very issue in litigation. This is what is meant by conflict.*" (43 F.R.D. at 468, emphasis added).

Musicians, 372 F.2d 155, 162 (2d Cir. 1967), *rev'd on other grounds*, 391 U.S. 99 (1968), it held that in order "to assure due process of law for the absent members" and since "all members of the class are to be bound by the judgment", "diverse and potentially conflicting interests within the class" are "incompatible with the maintenance" of a class action.* In *Papilsky* v. *Berndt*, 466 F.2d 251, 259-260 (2d Cir.), *cert. denied*, 409 U.S. 1077 (1972), it said that "uncertainty about the adequacy of the representation" would raise "a serious due process question" since "if nonparty stockholders are to be conclusively bound by the results of an action prosecuted by a stockholder ostensibly representing their interests . . . fundamental considerations of fairness and justice demand that the representation be adequate." And in *Hagans* v. *Wyman*, 527 F.2d 1151, 1154 (2d Cir. 1975), this Court noted that when interests of class members "are in fact antagonistic to those ostensibly representative," these persons "cannot properly be bound to an adjudication taken in their names."

The necessity for adequate protection of absent class members stems from the fact that the very essence of a class action is that class members are to become legally bound by a final adjudication, even though they are not parties present before the court. A necessary corollary of this is that absent class members may attack an adverse judgment simply by raising the claim that, somewhere along the line in the litigation, their interests were not fairly or adequately represented. Thus, if an expensive and complex class action such as the present suit is permitted to proceed with a plaintiff of this nature as a class representative, defendants, even if they weather all of the incumbent burdens and settlement pressures and prevail

* The Supreme Court, although it reversed this Court's decision on the merits, expressly approved its determination on the class action question (391 U.S. at 103 n.4).

at trial, will hardly have won the day. For then, absent class members and their counsel will be able to subject the entire lengthy course of the litigation to a hindsight review, questioning whether plaintiff named the right defendants, took the right discovery, and, most importantly, sufficiently pressed at trial the issues as to which he had personal exposure. And the only possible losers in this game can be the defendants, who at the least will have substantial further expense tacked on to what is already an almost prohibitively expensive undertaking, and at the worst run the risk of having to undergo a second trial with millions of dollars again at stake.

This risk, we must point out, is hardly a theoretical or remote one. For example, in *Gonzales* v. *Cassidy*, 474 F.2d 67 (5th Cir. 1973), it was held that plaintiffs were not bound by "the *res judicata* effect of a prior class suit involving the same class . . . the same defendants and the same issues," since the prior class representative—after satisfying his own interests—had failed to adequately represent the absent class members in his prosecution of the action (*id.* at 69). In sustaining class members' collateral attack on the class action judgment, the Court emphasized the principle that

> ". . . Due process of law would be violated for the judgment in a class suit to be res judicata to the absent members of a class unless the court applying res judicata can conclude that the class was adequately represented in the first suit. Hansberry v. Lee, 311 U.S. 32, 61 S.Ct. 115, 85 L.Ed. 22 (1942)." (474 F.2d at 74.)

The Court further suggested that this problem may be avoided if a court "stringently" applies the adequacy of

representation requirement in making its initial class action determination:

> "The 1966 amendments to Rule 23 eliminated the distinctions between true, hybrid and spurious class actions and the differing res judicata effect of each type of action, thus broadening the effect of res judicata under the amended rule. It follows then that *a court—whether it be the trial court making its initial 23(a)(4) determination, or a subsequent court considering a collateral attack on the judgment in a class action—must stringently apply the requirement of adequate representation . . .*" (*Id.* at 74-75, emphasis added.)

In *Popkin* v. *Wheelabrator-Frye, Inc.*, CCH Fed. Sec. L. Rep. ¶ 94,091 (S.D.N.Y. 1973), the Court—following this Court's observations in *Popkin* v. *Bishop*, 454 F.2d 714, 720-721 (2d Cir. 1972)—sustained a collateral attack on a representative party's adequacy of representation in the context of a minority stockholder's action under the securities laws.

In that case, a stockholder of Bell Corporation ("Bell"), sought to maintain a class action, attacking as "grossly unfair" the exchange ratios in a merger involving Bell and three other constituent corporations (*id.* at p. 94,369).

Defendants contended that plaintiff was bound by a prior judgment entered in a state court derivative action, where it was held (after notice to all stockholders, opportunity for objections, and a referee's report on a proposed settlement) that the merger exchange ratios were "fair, reasonable and equitable."

However, the Court—pointing out that the only Bell stockholder who was a plaintiff in the prior action also owned stock in another constituent corporation to the

merger and thus had conflicting interests—refused to accord the prior judgment a binding effect, since it was found that

> ". . . it cannot be stated that the plaintiffs in the New York derivative suit . . . fairly and adequately represented the interests of the minority stockholders of Bell" (p. 94,371).

In consequence, the Court concluded that plaintiff was free to maintain a new class action, since ". . . to hold otherwise would amount to a violation of due process . . ." (*Id.*)

In so holding, the Court, as noted, followed the guidance provided by this Court in *Popkin* v. *Bishop,* 464 F.2d 714, 720-721 (2d Cir. 1972), a case involving the same challenged merger, where the Court, in *dictum,* expressed "serious doubt" as to whether Bell stockholders were barred by the prior judgment, "since the only named plaintiff who owned Bell stock was also a shareholder of [another constituent corporation]."

As *Popkin* indicates, post-judgment collateral attack has been successful even when the initial judgment is the result of careful judicial scrutiny, and the conflict involved hardly as fundamental as that in the present case. We submit that there is no reason, in law or logic, for defendants to be subject to risks of this nature, and that this Court should reaffirm the principle, as summarized in *William Penn Management Corp.* v. *Provident Fund for Income, Inc.,* 68 F.R.D. 456, 459 (E.D. Pa. 1975), that:

> "The constitutional guarantee of due process of law requires that no person be bound by a decision in a case in which he is not an actual litigant unless, inter alia, his interests are adequately represented. *Hansberry* v. *Lee,* 311 U.S. 32, 61 S.Ct. 115, 85 L.Ed. 22 (1940). This concept of adequate representation is especially important in class action litigation under Federal Rules of Civil Procedure 23. Consequently,

> *'adequate representation' requires, at a minimum, that the representative party have no interests which may conflict with those of the persons he purports to represent.''* (Emphasis added.)

Finally, we suggest that the principles here at stake are akin to those given force by this Court in its recent decisions involving the disqualification of counsel in "conflict" situations. In these cases, the Court has emphasized "the public's interest in the scrupulous administration of justice" (*Hull* v. *Celanese Corporation*, 513 F.2d 568, 570 (2d Cir. 1975)), and the necessity to avoid "not only the fact, but even the appearance of representing conflicting interests" (*Cinema 5 Ltd.* v. *Cinerama, Inc.*, 528 F.2d 1384, 1387 (2d Cir. 1976)). And the Court has made it clear that disqualification must result if there is even the slightest possibility that there will be "compromising influences and loyalties," or if future litigation judgments might be tainted by conflicting considerations. As the Court put it in the *Cinema 5* case, in this situation, the party with the putative conflict bears the "heavy burden" of showing "at the very least, that there will be no actual or *apparent* conflict in loyalties or diminution in the vigor of representation" (528 F.2d at 1387, emphasis by the Court).

We submit that the same test should be applied in the present situation, where the interest in the "scrupulous administration of justice" is at least as great, and where the risk of divided loyalties affects not only the named parties, but a host of absent class members entitled to their rights under the due process clause. And, we submit, when this test is applied to the case at bar—where plaintiff has already admitted that he has knowingly wronged the class he now seeks to represent, and where counterclaims are pending against him based on his conduct—there can be no question that plaintiff cannot be a proper class representative.

CONCLUSION

For the reasons above stated, the decision and order of the District Court should be reversed.

Respectfully submitted,

Marc P. Cherno

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON
Attorneys for Appellant
Penn-Dixie Industries, Inc.

ARANOW, BRODSKY, BOHLINGER, BENETAR & EINHORN
Attorneys for Appellants
Jerome Castle, Omar J. Glantz,
James C. Jacobsen, Harvey Kushner,
Alfonso J. Marcelle and
James F. Morrill

Of Counsel:

MARC P. CHERNO
JOSEPH H. EINSTEIN
ALAN J. RUSSO

November 9, 1976